DEPARTMENT OF STATE REVENUE

04-20150146.LOF

Letter of Findings Number: 04-20150146
Sales and Use Tax
For Tax Years 2011-13

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Manufacturer was able to establish that portions of the tangible personal property at issue were either not subject to sales and use taxes or were only partially subject to tax. The remaining portions remained subject to tax as originally determined. Negligence penalty was properly imposed.

ISSUES

I. Use Tax–Additional Purchases.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1; IC § 6-8.1-5-4; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wendt LLP v. Indiana Dept. of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); 45 IAC 2.2-3-4; 45 IAC 2.2-5-8.

Taxpayer protests a portion of the Department's proposed assessments for additional use tax.

II. Tax Administration–Penalties.

Authority: IC § 6-8.1-5-4; IC § 6-8.1-10-1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of penalties.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid sales tax on all taxable purchases during the tax years 2011, 2012, and 2013. Due to the large number of invoices at issue, the Department and Taxpayer agreed to use a sample and projection method to determine Taxpayer's compliance rate for those years. The Department then applied that compliance rate to Taxpayer's total purchases for those years. The Department therefore issued proposed assessments for use tax, penalties, and interest for those years. Taxpayer protested a portion of the proposed assessments and the imposition of penalties. In order to stop the accrual of interest, Taxpayer paid the proposed assessments while maintaining its protest. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax–Additional Purchases.

DISCUSSION

Taxpayer protests a portion of the proposed assessments for use tax for the tax years 2011, 2012, and 2013. The Department based its proposed assessments on the results of a sample and projection method which it used to determine Taxpayer's compliance percentage. That compliance percentage was applied to Taxpayer's total purchases to determine the difference, if any, between that compliance percentage and what Taxpayer actually paid in sales taxes and use taxes for the tax years. The Department found that the compliance percentage was higher than what was actually remitted and issued proposed assessments for use tax on the amount of the difference. Taxpayer protests that some of the items listed in the sample and projection calculations as taxable but with no tax paid were either not taxable purchases or were partially taxable and partially exempt purchases.

This difference, Taxpayer asserts, would reduce the compliance percentage and therefore the difference between that compliance percentage and what was actually paid would be smaller. Thus, Taxpayer states, the proposed assessments would be correspondingly reduced.

Prior to the administrative hearing, Taxpayer and the Department's audit staff addressed Taxpayer's concerns regarding the audit results. As a result of these communications, the Department revised its initial audit findings. The Department agreed to remove taxable amounts for Stratum 3, Sort 1 and for Stratum 5, Sort(s) 142, 143, 144, and 145. The Department also removed sorts with missing invoices listed as taxable if the vendor in question only sold manufacturing equipment. The Department did not remove sorts which Taxpayer provided invoices showing sales tax paid at the time of purchase. The Department determined that Taxpayer had a direct pay permit and had removed sales tax from the total amount on the invoice before paying. The end result of the pre-hearing discussions was a reduction of approximately $7,738.96 from the initial calculations of tax due. The Department remained convinced that the remaining amounts of use tax were still correct. Taxpayer continued to protest a portion of those amounts.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . .[courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Sales tax is imposed by IC § 6-2.5-2-1, which states:

> (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
> (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Use tax is imposed under IC § 6-2.5-3-2(a), which states:

> An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

45 IAC 2.2-3-4 further explains:

> Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when sales tax is not paid at the time TPP is purchased, use tax will be imposed unless the purchase is eligible for an exemption.

Also of relevance is IC § 6-2.5-5-3(b), which states:

> Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Taxpayer states that several items listed in the Department's sample population as subject to tax but upon which tax was not paid at the point of purchase were either not subject to tax at all or were partially taxable and partially exempt. In the course of the protest process, Taxpayer provided a spreadsheet listing all of the items which it believes should be adjusted wholly or partially non-taxable in the Department's projection calculations. For some of those items under protest, Taxpayer provided invoices in support of its position. For the remainder of the items,

Taxpayer provided its estimates of exempt use as determined by its plant manager. Taxpayer believes that the plant manager has the day-to-day experience and knowledge to provide an accurate estimate of any particular item's exempt usage. Taxpayer also provided calculations of the results of recategorizing the protested items as non-taxable and recalculating the compliance rate as determined via the projection calculations.

As noted above, the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, under IC § 6-8.1-5-1(c). In the case of items for which no invoice was provided, the Department cannot agree with Taxpayer's protest. While Taxpayer's plant manager may have made the estimations in good faith, estimations are simply not sufficient to meet the burden imposed by IC § 6-8.1-5-1(c). As provided by IC § 6-8.1-5-4:

> (a) Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.
> (b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:
> (1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or
> (2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction. In addition, if the limitation on assessments provided in section 2 of this chapter is extended beyond three (3) years for a particular tax liability, the person must retain the books and records until the assessment period is over.
> (c) A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times.
> (d) A person must, on request by the department, furnish a copy of any federal returns that he has filed.
> (Emphasis added).

Thus, with regard to those items under protest for which Taxpayer was unable to provide invoices in support of its position regarding the taxable status of those purchases, Taxpayer's failure to comply with the record-keeping requirements of IC § 6-8.1-5-4 results in its inability to meet its burden under IC § 6-8.1-5-1(c) of proving those portions of the proposed assessments wrong.

Additionally, Taxpayer states that the sample population contained certain purchases in which a certain high percentage (for example, eight out of ten invoices) were available for the same type of items were purchased from the same vendor and were considered not subject to use tax. The missing invoices were considered subject to tax. Taxpayer believes that the Department should extrapolate the compliance rate for the available invoices to the missing invoices, resulting in a one hundred percent compliance rate for purchases of that type of TPP from that vendor and then apply that rate to its overall projection calculations.

The Department does not agree to this proposal. Functionally, Taxpayer wants the Department to apply a projection for certain vendors to the overall projection calculations. The Department finds this to be contrary to the record keeping requirements of IC § 6-8.1-5-4 described above. Therefore, with regard to missing invoices from any vendor the Department will not extrapolate unverified compliance, whether or not other invoices from that vendor are available. Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

Next, Taxpayer states that certain purchases listed as subject to use tax in the sample population were actually payments for forklifts and that the Department's audit calculated a sixty-nine percent taxable rate for forklifts. Taxpayer provided copies of the invoices for these payments. Taxpayer believes that the audit's taxable rate should be applied to these forklift invoices. After review, the Department agrees that the same taxable rate determined for other forklifts should be applied to these forklift payments. For these invoices, Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c).

Next, Taxpayer states that several items listed as one hundred percent taxable in the Department's calculations were actually "Non-stock storeroom items" purchased from one particular vendor ("Vendor") which were specifically taxed at thirty four percent in the audit report. Taxpayer argues that other such non-stock storeroom items should be taxed at thirty four percent as well. Taxpayer contracted with Vendor from January 2011 to September 2011.

The Department based this determination on the fact that Vendor's charges included labor, stores inventory purchases, and related freight charges for stock and non-stock items. The thirty four percent taxable rate was

applied to material purchases and the related freight charges for charges from Vendor between January 2011 and September 2011. After September 2011, taxable purchases were determined on an individual basis. A review of the invoices supplied in the protest process does not show any invoices from Vendor. Therefore, the Department does not agree that all invoices for non-stock storeroom items should be taxed at thirty-four percent. Those non-Vendor invoices were examined in the same manner as all other invoices and stand on their own merits. Therefore, regarding the non-stock storeroom items, Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c).

Next, Taxpayer protests that certain purchases of safety equipment should be removed from the Department's calculations as taxable purchases. Taxpayer refers to 45 IAC 2.2-5-8 which provides in relevant parts:

> . . .
> (c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
>
> -EXAMPLES-
>
> (1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.
> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.
> (A) Air compressors used as a power source for exempt tools and machinery in the production process.
> (B) An electrical distribution system, including generators, transformers, electrical switchgear, cables inside or outside the plant, and related equipment used to produce and/or supply electricity to exempt manufacturing equipment used in direct production.
> (C) A pulverizer for raw materials to be used in an exempt furnace to produce and/or supply energy to manufacturing equipment used in direct production.
> (D) Boilers, including related equipment such as pumps, piping systems, etc., which draw water, or produce and transmit steam to operate exempt machinery and equipment used in direct production.
> (E) A work bench used in conjunction with a work station or which supports production machinery within the production process.
> (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.
> (G) An automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry.
> . . . .
> (Emphasis added).

A review of the audit report shows that the Department did allow exemptions for safety equipment which allowed Taxpayer's employees to participate in the production process without injury or to prevent contamination of the product during production. Therefore, invoices provided during the protest process regarding purchases of safety equipment will be removed from the taxable category in the sample population of the Department's compliance rate calculations.

Taxpayer's final point of protest is in regards to purchases of what it states are either repair parts or repair services for production equipment. As explained above, IC § 6-2.5-5-3(b) does provide an exemption for tangible personal property used in the manufacturing process. However, Taxpayer has only provided its own statements that the tangible personal property in question was used to repair or service manufacturing equipment. Such statements alone do not meet the requirement of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has met its burden of proving the proposed assessments wrong under IC § 6-8.1-5-1(c) regarding forklifts and safety equipment. In all other points of protest, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c). Therefore, the Department will recalculate

Taxpayer's compliance rate after removing the amounts for forklift and safety equipment payments from the taxable category in the sample population. The Department will then apply the new compliance rate as before and will arrive at a new amount of use tax which was due for the tax years at issue. Since Taxpayer has already paid the assessments, this will result in a refund which will be calculated after the recalculation and application of the revised compliance rate.

FINDING

Taxpayer's protest is sustained in part and denied in part, as explained above.

II. Tax Administration–Penalties.

DISCUSSION

Taxpayer protests the imposition of penalties pursuant to IC § 6-8.1-10-2.1. Penalty waiver is permitted if the taxpayers show that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> "Negligence", on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer protests the Department's assessment of penalties. While Taxpayer has been sustained in part under Issue I above, regarding the amount of use tax due, it remains that Taxpayer has also been denied in part in Issue I. Therefore, Taxpayer failed in its duty to keep a substantial percentage of its purchase records as required under IC § 6-8.1-5-4(a). Taxpayer has not affirmatively established that it exercised ordinary business care in this case. Therefore, waiver of penalties is not warranted under 45 IAC 15-11-2(c). However, since Taxpayer was partially sustained in Issue I above, penalties will be correspondingly reduced after recalculation of use tax due.

FINDING

Taxpayer's protest to the imposition of penalties is denied.

SUMMARY

Taxpayer's Issue I protest regarding the imposition of use tax is sustained in part and denied in part. Taxpayer's Issue II protest regarding the imposition of penalties is denied.

Posted: 04/27/2016 by Legislative Services Agency
An html version of this document.